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SUBJECT: KENYA: GOVERNMENT BORROWING AND COSTS WILL RISE

REFS: A) Nairobi 353 B) NAIROBI 192

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¶1. (SBU) Summary: Government of Kenya (GOK) officials are trying to maintain confidence and prevent financial panic by claiming the current crisis will be short-lived and thus will not have a major impact on the GOK's revenue, spending, borrowing, or interest rates. However, the bids at the January 24 auction of government securities indicate the financial sector expects inflation and interest rates to rise as tax revenues decline and the GOK is forced to borrow more from the domestic market and/or cut spending. That said, the GOK should be able to meet its financing needs and cover the increased cost of borrowing. End Summary.

GOK Officials Minimize Financial Impact of Crisis

¶2. (U) GOK officials claim that the month-long political crisis, which has handcuffed the economy (ref A, Randy's econ collapse cable) is a temporary blip, and that inflation, government spending and borrowing, and interest rates will not rise significantly. Finance Minister Amos Kimunya claimed on January 29 Kenya would suffer only a slowdown in economic activity in the first six months, not a recession, because Kenya's fundamentals are still sound and a solution will be found soon to the political crisis. Kimunya acknowledged the tourism sector would take longer to recover than other sectors and that revenue collection would fall below the FY07/08 target of Ksh406.9 billion (about $6 billion), but claimed the Ksh8 billion (about $118 million) collected in the first half of the year, plus the extra Ksh20 billion (about $294 million) collected in the privatization of former state-owned telephone monopoly Telkom Kenya would cushion the shortfall.

¶3. (U) On January 20, Kenya Revenue Authority (KRA) Commissioner General Michael Waweru claimed his agency would meet its FY07/08 tax collection target of Ksh410 billion (about $6.3 billion), even though the crisis would undermine business confidence and activity. The deficit planned for the FY07/08 budget was Ksh109.8 billion (about $1.7 billion, 5.3% of GDP), of which Ksh40 billion (about $570 million) would be domestic borrowing, Ksh26 billion (about $400 million) would be funded by privatization proceeds, and Ksh39.8 billion (about $615 million) would come from donors. The GOK received Ksh 20 billion (about $294 million) more than expected from the sale of Telkom Kenya, but another even larger privatization, an initial public offer for cellphone giant Safaricom, could be delayed past the June 30 end of the fiscal year. Further, donors are reviewing their programs in light of the insecurity and the need for

politicians to reach some agreement before they can resume business as usual. Neither Waweru nor Kimunya explained how they would compensate for the loss of most of the tax revenue from the Ksh65 billion/year (almost $1 billion) tourism sector.

¶4. (SBU) The GOK officials' optimism about tax revenues ignores the dire forecasts from the private sector that the Kenyan economy lost tens of billions of shillings in January, and that the losses could exceed Ksh200 billion (about $2.86 billion) and 500,000 jobs in the first half of the year if no political settlement is reached within the next few weeks. The January 26-28 upsurge in violence and the ensuing plunge of the Nairobi Stock Exchange and the shilling also demonstrated that risk factors have risen (Ref A).

GOK Borrowing and Interest Rates Will Rise

¶5. (U) The GOK is going to face high costs for dealing the crisis, including reconstruction assistance for the displaced persons, repairs to roads and other public infrastructure, and security. Kimunya has announced he will ask Parliament for more money when it opens in March to finance security cost overruns, but did not explain where the money would come from.

¶6. (SBU) The GOK has difficulty spending its capital budget even during normal times, which tends to bring the deficit below the budgeted level. While financial markets assume the GOK is likely to maintain fiscal discipline, they also assume it will have to borrow more than planned from the local market. Central Bank of Kenya (CBK) Governor Njuguna Ndungu has tried to keep up investor confidence in the economy. Rather than calling a formal emergency meeting of Monetary Policy Advisory Committee (MPAC), Ndungu used a meeting of the informal market leaders' forum on January 21 to insist that economic fundamentals remained intact, that 8% growth was still possible in 2008, and to urge big investors to continue to buy T-Bills and bonds at previous rates.

¶7. (SBU) However, Ndungu did not convince the financial sector to play ball. Rather than the usual large oversubscription, the January 24 auction of Treasury bonds and bills received bids covering only 79.8% and 91.4% of the offer respectively. Such under-subscription is unusual. The government offered 5-year, Ksh7.0 billion (about $103 million) Treasury bonds at a coupon rate of 9.5% to meet part of the cost of rolling over Treasury bonds maturing in the next month. Treasury received bids totaling only Ksh5.58 billion (about $82 million), of which only Ksh4.7 billion (about $69 million) were at or below 9.5%. The average 91-day Treasury bills rate edged up by 11.6 basis points during the January 24 auction to 7.115% while the average 182-day Treasury bills rate edged up by 5.7 basis points to 8.089%. In December, nearly all banks were awash with cash, and banks still see government securities as a safe investment. In the wake of January's violence, a senior dealer at a major bank confirmed the main players have liquidity, expect interest rates to go up, and are waiting for the GOK to offer a higher rate.

But the GOK Can Pay

¶8. (SBU) Even if GOK borrowing and servicing costs rise, the GOK should have no problem servicing its short-term debts, domestic or foreign. The CBK reported on January 25 that cumulative government expenditure on interest and other charges on domestic debt from July 1, 2007 to January 18, 2008 increased 16.3% YOY to Ksh21.4 billion (about $315 million), but that this represented a small decline to 10.1% of the GOK's ordinary revenue from the previous year.

Comment

¶9. (SBU) GOK officials' cheerleading has not prevented the financial sector from recognizing the GOK will have to borrow more than planned in 2008 to cover reduced tax revenues and the costs of dealing with the crisis. Investors still have confidence the GOK will maintain its fairly sound fiscal and monetary policies, even if it requires cutting planned development and capital expenditures. Investors will continue to buy government securities, but will demand higher rates to cover risk and inflation.

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